DOW THEORY LETTERS INC.

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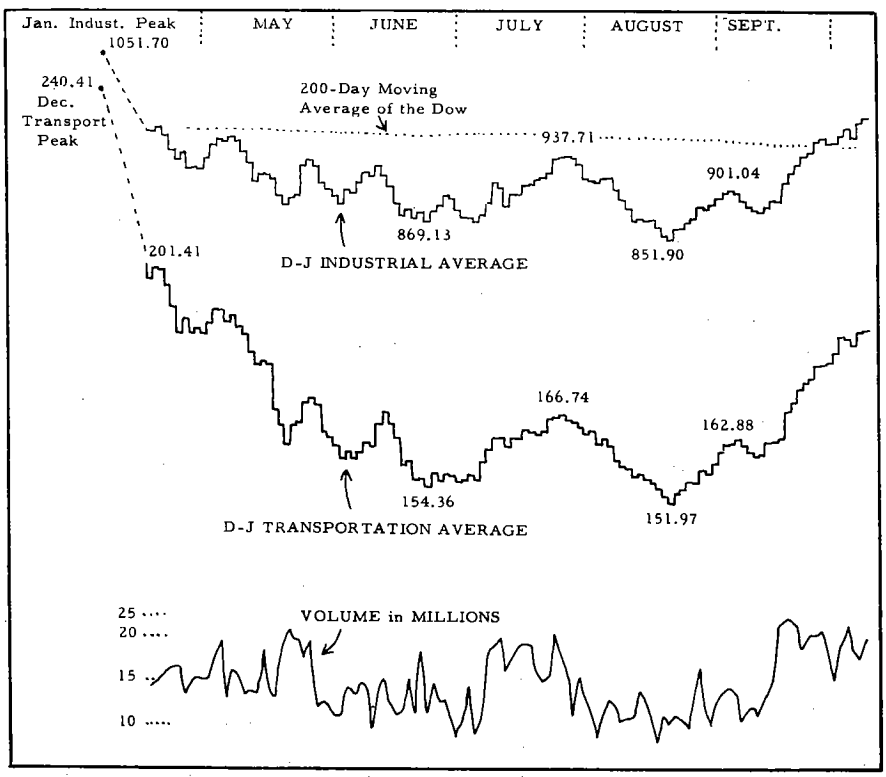
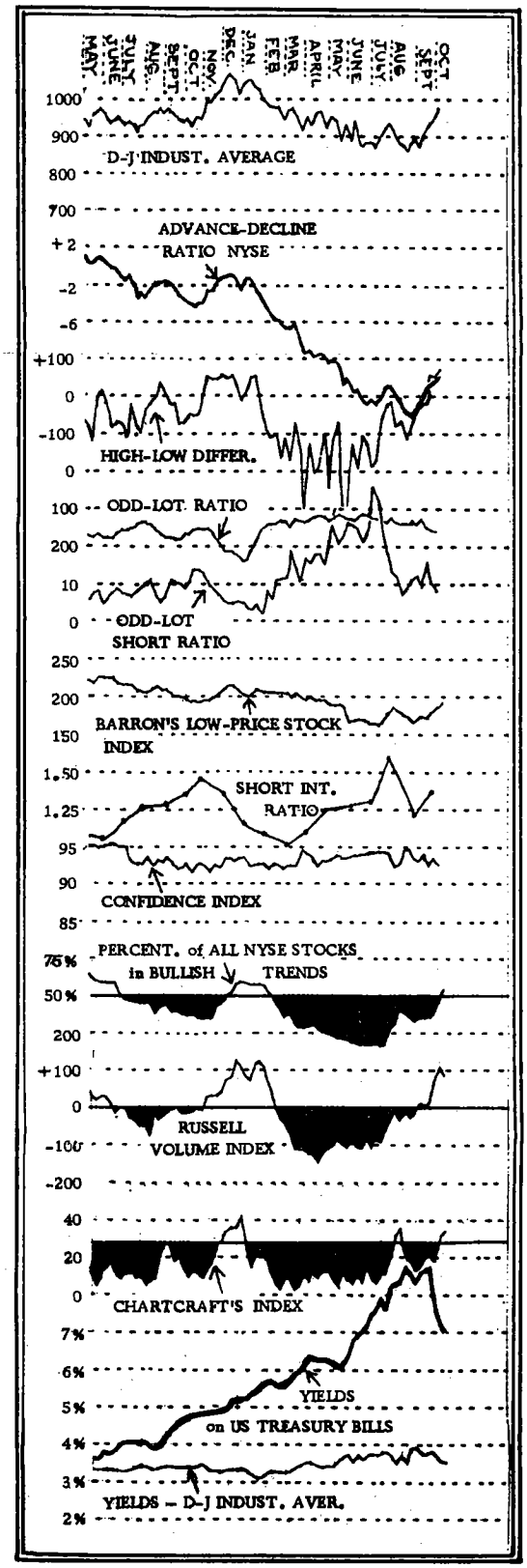
THE PICTURE: This report goes into detail about the gold and money situation, simply because there is much unannounced "news" occurring on that front. Furthermore, it is extremely difficult to glean gold-monetary information and even harder to make sense out of it. The economic world is no longer simply the Communists and the West. It is increasingly one world, and the massive and critical battles now being waged behind the scenes in Europe, the Middle-East, the US, the Comecon (Communist-Russian) nations and China (plus the undeveloped nations) would boggle the mind. For thousands of years gold has moved towards the centers of power, and the centers of power have attracted gold. Cut through the mish-mash and lies and find out where gold is going, and you will uncover the path to the men and nations who run the world.

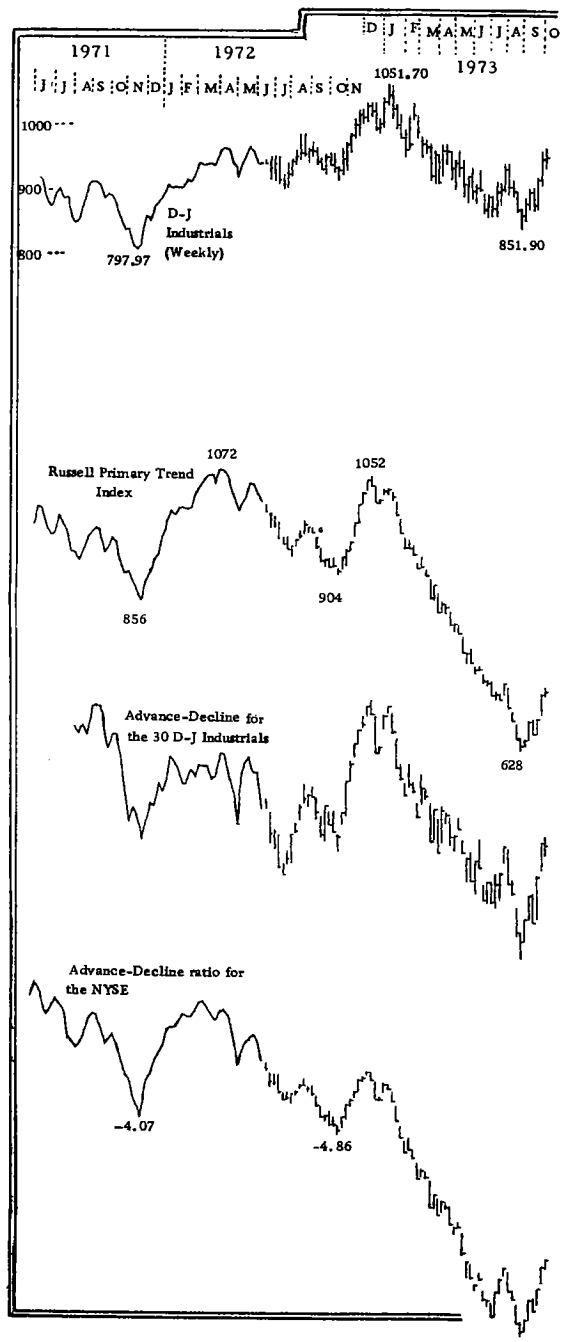
As to Wall Street, the market is running true to form — but not quite. It is running true to form in that the famous "one-decision" glamor stocks (IBM, Avon, Disney, etc.) have swooned, but many of the secondary and cyclical stocks are pushing higher with a vengeance. Already, the basic argument is whether we are seeing a normal and in fact long-overdue correction in the primary bear market which began in 1966, or whether a new primary bull market has finally begun.

The bull market thesis is now particularly strong, and the bulls have the added ammunition of being able to point to many stocks which are at what appear to be extremely low price/earnings ratios. Furthermore, the bulls can point to the massive collapse in the advance-decline ratio and in the geometric averages (such as Value-Line), and they state that by "normal standards" they are buying the bargains which have been created by 1973's truly breath-taking cave-in.





All of these are good arguments, but unfortunately, I do not feel that these arguments tell the whole story.



I started pulling in my near-term bearishness around July, at which time I noted that the Dow had created a near-record by declining six months in a row (a feat that was surpassed only once before in history, during the depth of World War II in 1942).

Great fortunes in the market are usually made by men who enter a primary bull market near its inception and ride it out to somewhere near its ultimate conclusion. It is the nature of a true bull market literally to move almost all stocks higher in due time. Mistakes, wrong guesses, stupidities, all are erased as a true bull market pushes up everything that is not nailed down.

Bear market rallies do not work the same way. They grow out of the oversold cave-ins of bear market collapses, and they are frequently so explosive that they look considerably "more bullish" than the long, often-grinding rises which characterize a bull market advance. I believe that this is the kind of market we have been witnessing since the August lows. I am not "knocking" this advance, and anyone who purchased any of the seven strong Dow stocks which I have mentioned since Letter 573 can hardly be disappointed with the action since September. Nevertheless, this violent rally (amid cave-ins in many glamor issues) does not stem from a true bear market bottom. I believe it is a beautiful bear market rally, and that it has materialized because the market was exhausted on the downside and simply tired of probing the lower depths.

The accompanying weekly chart will help to put the whole picture in perspective. The chart presents weekly profiles of the Dow Industrials and three of the indicators which I find outstandingly useful. Note that during the 1973 smash, the Dow alone held above its 1971 low. This presents an interesting technical problem, since on a relative strength basis the Dow has been far superior to almost any other index or average in the technician's chartbook. On a simple technical reading of this picture, this would imply that the Dow would be the leader on the next advance (since it is totally reasonable to assume that the Dow would retain its superior relative strength on the next, actually the present, advance).

Although not generally conceded, it has been the Dow which has put on the best performance since the August 22 lows. This is seen most dramatically in the Primary Trend Index (PTI) which has been held back somewhat by recent hesitant action first in bonds, then utilities. The A-D ratio of the 30 Dow stocks has been strong and the A-D ratio for the entire NYSE (bottom index) has kept up with the Dow on the advance. Nevertheless, as I stated in reports since Letter 573, I would prefer that traders on this move stay with the "strongest Dow stocks" (see end of this Letter).

In the last Letter I presented a chart showing the bullish percentages in three indices, all NYSE stocks, all groups, and in the 30 Dow Industrials. My latest figures show upside breakouts in all three indices above the critical 50% level and above the trendlines (refer to the last Letter). The figures are as follows, 52% of all stocks are in bullish trends, 64% of all groups and 63% of the Dow stocks.

The fact is that in very short order almost all indicators have turned bullish, and this market is enjoying the "euphoria" I referred to in the last two mailings. In the next report I will go into a new study, "momentum," and how it can call the early signs of the termination of a movement (with application, of course, to the current rise).

GOLD, MONEY, OIL: At 11:24 AM, October 3, the following news item (see page 3) came over the D-J ticker tape. This is one of the most extraordinary stories to come out of the entire international gold and monetary struggle. It must be assumed that French Minister D'Estaing is (as usual) speaking for the leading European nations. What is he saying and what are the implications? D'Estaing is saying, "All right, after the absolute 'zero' of Nairobi we are giving up on the US doing anything

on monetary reform. Everything we suspected about the US position has proved to be correct. The US has no intention of doing anything except waiting and hoping that somehow the situation will ultimately militate in favor of America and the dollar. But Europe sees the danger of the present course, and it will not wait."

FRANCE CONCEDES DEFEAT IN EFFORT
TO MAINTAIN GOLD'S SUPREMACY

PARIS -DJ- FRANCE CONCEDED THAT IT HAS LOST ITS LONG BATTLE AIMED AT GIVING GOLD A KEY ROLE IN THE REFORMED INTERNATIONAL MONETARY SYSTEM AND ACCEPTED ITS GRADUAL DEMONETIZATION.

IN A LONG INTERVIEW WITH THE NEWSPAPER LE MONDE FINANCE MINISTER GISCARD D'ESTAING SAID NEITHER SPECIAL DRAWING RIGHTS NOR CURRENCIES WILL BE DEFINED BY THE WEIGHT OF GOLD IN THE NEW SYSTEM

CURRENCIES WILL BE DEFINED IN RELATIONS TO ONE ANOTHER THROUGH THE INTERMEDIARY OF SDRS WHICH WILL BECOME THE 'REAL NUMERAIRE' OF THE NEW MONETARY SYSTEM HE SAID.

-0- 11 24 AM EDT

So far so good. France tells the world that the US has "won," and this leaves Europe free to pursue its own policies and interests. What happens next?

(1) Actually, it seems increasingly clear that Europe is going to move towards "re-monetization" of gold. This means that Europe intends to keep gold in its various central banks as a reserve. Furthermore, the Arabs now have a gold-backed currency, and this opens the door to further dealings with the oil-rich nations (a vital necessity for Europe). Finally, the Russian economic nexus, the Comecon nations, have expressed great interest in an economic detente with the EEC. Should the ruble become gold-backed (which I believe will take place in time), the stage will be set for a huge new monetary system from which the US could well be isolated. But the first move will probably be in Europe, and as C. Gordon Tether, the money expert of the London Financial Times put it, "Everybody on the European side is saying that we ought to get back to some orderliness in the money markets by establishing partial convertibility in gold in the European countries."

(2) Here are some further cogent thoughts: No one can tell people what true value or real money is. You can take gold out of the world monetary system, but if people think gold is true "money" (with a built in store of value based on 5,000 years of history and world-wide acceptance) they will want to own gold, and they will consider it the real money.

(3) If gold is "demonetized" as the US so ardently desires, then there is no further reason at all for the (US-sponsored) "Official Gold Price" of $42.22. The only price for gold will be the market price.

(4) If the US were to have its dream of a gold-less monetary system, why in the world should the US hold any quantity of gold in its Treasury, except what is needed for national defense purposes and industrial stockpiling? We certainly wouldn't need our $11 billion pile of gold. How would we justify a refusal to sell say $2 or $4 billion of gold for $2 to $4 billion of dollars which might be presented to us by perhaps an Arab nation or a group of European nations?

(5) Why did D'Estaing make his "French defeat" statement at this time? To my mind, the statement was prepared and ready days or weeks ago. D'Estaing and European monetary leaders knew that the US was not ready to do anything on monetary reform. The statement, coming only days after the Nairobi farce, was D'Estaing's way of saying that Europe tried, failed and now considers itself "off the hook" to the US. Europe now considers itself free to set up a system which will bring some monetary stability to Europe; it will no longer toy with IMF nonsense while the hurricane-winds of inflation blow ominously and while the world's currencies flap like loose sails in the wind.

It was interesting to observe the price action of gold bullion on the free market as the D'Estaing statement hit the news wires. The reaction (which might have brought shock or panic) was nothing. Gold held within a dollar or two of the $100 level, still triple the 1970 price. If gold were going to be cast out as a monetary relic, why was it still selling at roughly $100? The answer: whatever gold hit the market on the D'Estaing news was quickly picked up by other gold buyers. It is my personal opinion that large interests are now trying to "shake the gold tree" and pick up any under-$100 gold which may be available. So far, the pickings have not been very impressive.

No sooner did I finish this piece than I received a call from Douglas E. Johnston, the Texas gold expert who contributes so many fine articles to the Alden Wells Quarterly. Doug believes that the real battle is between the US "led" IMF and the hard-currency European nations under the auspices of the BIS (Bank for International Settlements). Johnston feels that D'Estaing is warning the US and the world that Europe is giving up on the IMF (with its new crowd of under-developed nations) as a possible center for monetary reform. France and Europe (with perhaps some sort of Arab alliance) are turning to the BIS. In brief, Doug Johnston feels, as I do, that Europe is getting ready to move. Gold will win, as it always has, although each time the method of victory is different.

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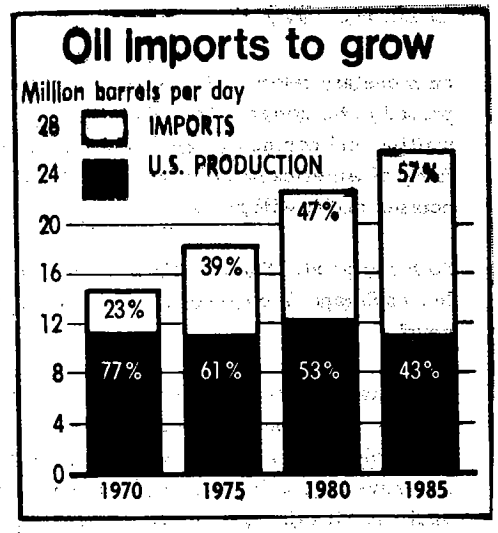
Great hopes are being kindled regarding our "improving balance-of-payment (BOP) situation." Yet I suspect that the current improvement is going to prove fleeting. The energy crisis is growing, and I include a chart (page 4) showing projected oil



imports. The price of oil has been raised around 40% by Libya and Syria, and this week's joint Arab oil meeting let it be known that a general 66% oil price boost can be expected (this before the new Israel-Arab war which could send the price even higher, see later section). I would guess that gasoline could be 50¢ a gallon within a matter of months, perhaps $1 a gallon within a year. The critical fact is that oil alone (in increasing import quantities) is going to push our BOP into the red again.

President Nixon announced that the US would be self-sufficient in energy within five years. This is utter nonsense. For instance, our total Alaskan oil reserves are figured at 10 billion barrels, about a two year's supply here (even if we could get that oil rolling within a few years). As to nuclear power as a replacement for natural power, glance at this recent quote from Dr. Harold Urey, one of the great nuclear brains of this nation, "The difficulty with nuclear breeder reactors is that they produce plutonium...Plutonium has a half-life of 24,000 years, and that means that for hundreds of thousands of years somebody must see that this plutonium doesn't get lost. One pound of plutonium uniformly distributed among all the people on earth would produce cancer in all of them. Almost certainly, accidents will occur. They always occur in everything we do, eventually."

To my mind, this means that for the time being, we must depend on increasingly expensive oil, and imported oil in increasing quantities. To offset this, we have our agricultural products, and the biggest factor in our recent BOP improvement was the tremendous increase in sales of agricultural output. Much of this was due to high farm prices which may now be coming down. But there are other problems here too, not the least of which is competition, which I feel is slated to grow. The Japanese are buying huge land tracts in S. America, for instance, and this land is earmarked for grains (after what recently happened, the Japanese do not want to face US export controls again!).

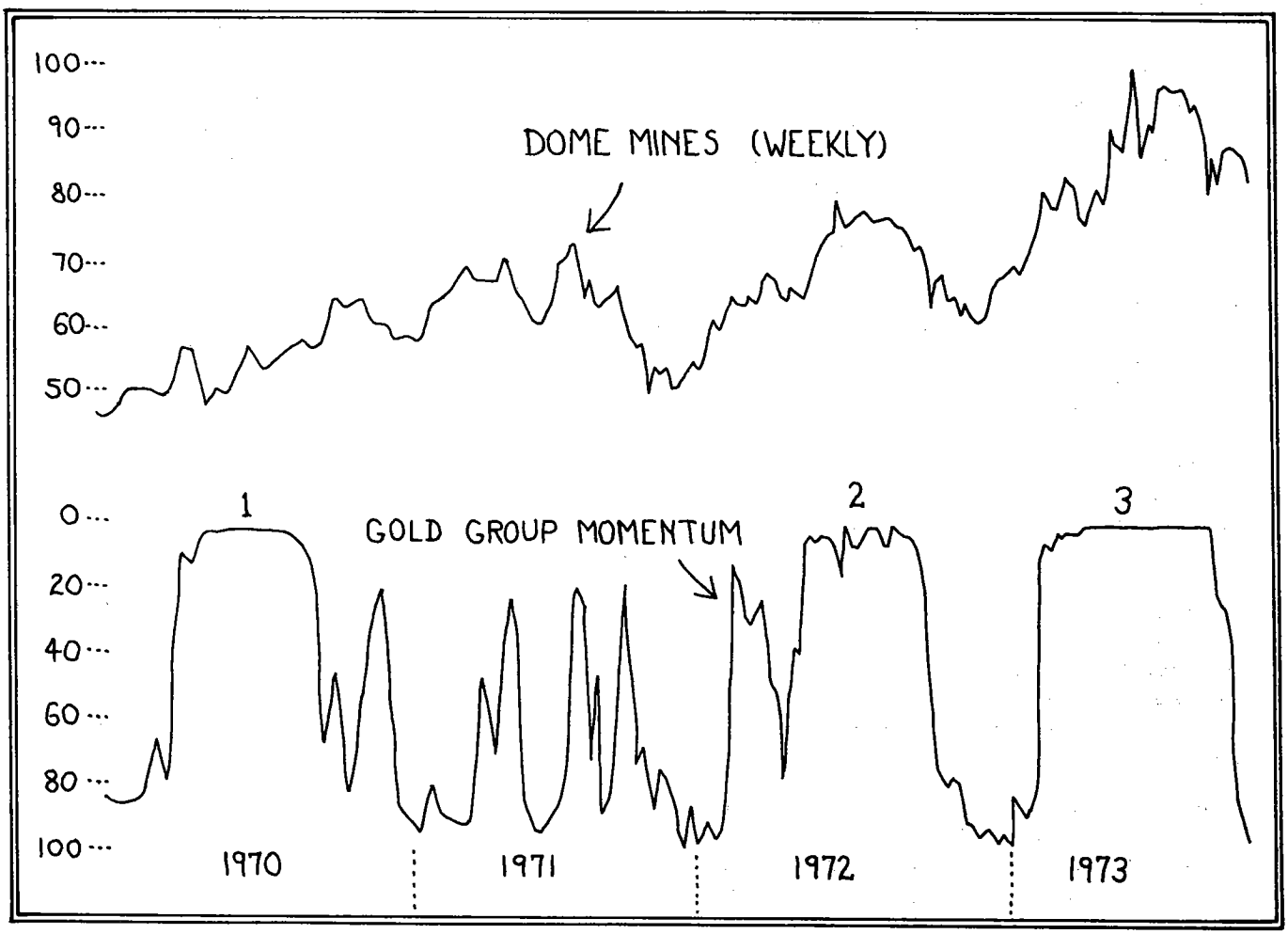
And as if that isn't problem enough, along comes an article in last week's Los Angeles Times regarding Dr. Walter Orr, president of the University Corp. for Atmospheric Research. Orr's research indicates that sunspots directly affect the earth's atmosphere. According to Orr the sunspot cycle follows a 20-22 year cycle and his studies indicate low sunspots and a crop-destroying drought here in 1975 or 1976, a drought rivaling the Dust Bowl days of the 1930's or the great drought of the 1950's. "I wouldn't be surprised," says Orr, "if we found ourselves very desperately strapped for water with none left for irrigation at all...I believe the days of crop surpluses are behind us."

So there's a thought, crop shortages, a cave-in of agricultural exports, and all this in the face of rising oil imports and increasing prices. Obviously, it all makes me wonder whether the BOP surpluses we are being promised are really going to materialize or whether we are again indulging in our famous hopes and dreams.

Economists Eliot Janeway and Henry Kaufman are perhaps the only two men in the nation who see what is really going on in the government spending picture. States Janeway in his latest report, "The big borrowing is just barely beginning." Janeway continues, "...Agency borrowing pressures are rapidly taking over as the big source of troublesome inflationary pressures from the governmental sector." In his Sept. 28 Salomon Bros. report, Henry Kaufman concurs: he shows that total government agency borrowing was up $6.3 billion for the year in 1969, $8.4 billion in 1970, $3.2 billion in 1971, $9.7 billion in 1972, and $17.4 billion for the first nine months of 1973 or 50% ahead in 1973! These facts might be digested by those who think easy money is just around the corner. It is clear that bulls on the money picture are not taking into account the forthcoming massive borrowings from agencies and from corporations.

ARAB-ISRAELI WAR: I do not think that the full meaning of the current disaster is being fully understood. Here are some of the points as I see it. (1) After Vietnam, the US will be most careful to confine all efforts to talking. Even if Israel goes under, the US will not move. (2) I believe Israel possesses nuclear capabilities. I do not see Israel going under without using those capabilities. (3) This war so far shows better coordination on the part of the Arabs. It could be much harder for the Israeli's to win than the 1967 war. (4) If the Arabs lose, there will be fantastic bitterness on the Arab part against the US (which they accuse of being pro-Israel). Iraq has already taken over Western oil interests. If the Arabs are beaten, more nationalization could occur, and the ultimate oil crisis could be vastly intensified. (5) If the war goes badly for the Arabs, they could put pressure on the West by cutting off the oil supply. (6) The stock market's first reaction to the war can best be described as "complacency." The stock market's first reaction to important news events is often contra to the course it will shortly follow.

STOCKS: I include on page 5 a chart of Dome Mines, a leading Canadian issue, together with the Gold Group Momentum Index as tabulated weekly. The momentum statistics are provided by Chartcraft, Larchmont, NY 10538. Each of the 96

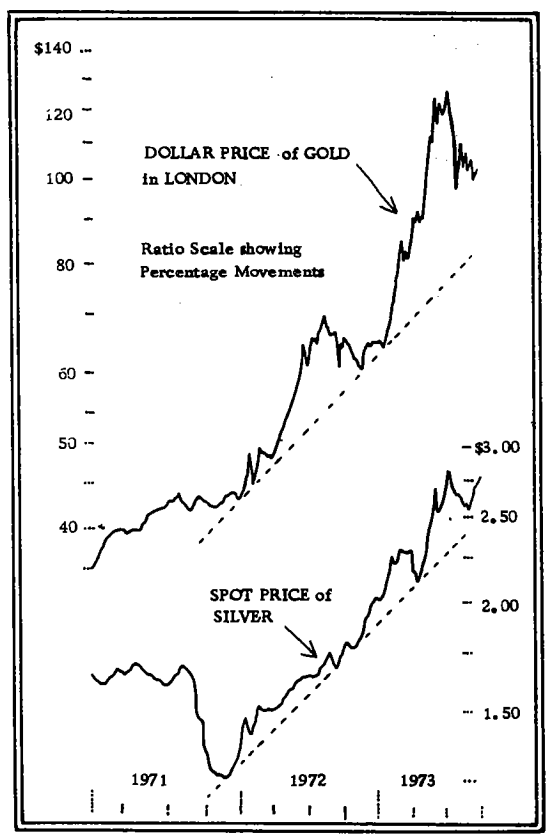


S & P stock groups are compared with the S & P Average and given a momentum number (for instance, number 5 would indicate that this group has the fifth highest momentum among the 96 groups). Chartcraft runs these momentum indices on the basis of a 17-week momentum cycle.

I have shown the momentum for the Gold Group, and note that since 1970 there have been three broad periods in which gold has been in the top spot. These three periods are numbered 1 (1970), 2 (1972) and 3 (1973). Note also that momentum (as now) for gold has dropped way off during the last quarter of each year, and that momentum starts up during the first quarter of each new year. It is interesting to see that since 1971 Dome Mines has been higher at each year-end period, even though those same periods saw the gold group momentum at a very low level.

This suggests that the present period of very low momentum for the gold group will give way to increasing strength starting with early 1974, but with the golds at a higher level than during early 1973. I suspect that 1974 will see a major rise in gold shares in line with a rise in Gold Group momentum as implied by the previous cycles on this chart. As far as I know, this study has never appeared in print before, and it should serve as an interesting timing device for gold-followers.

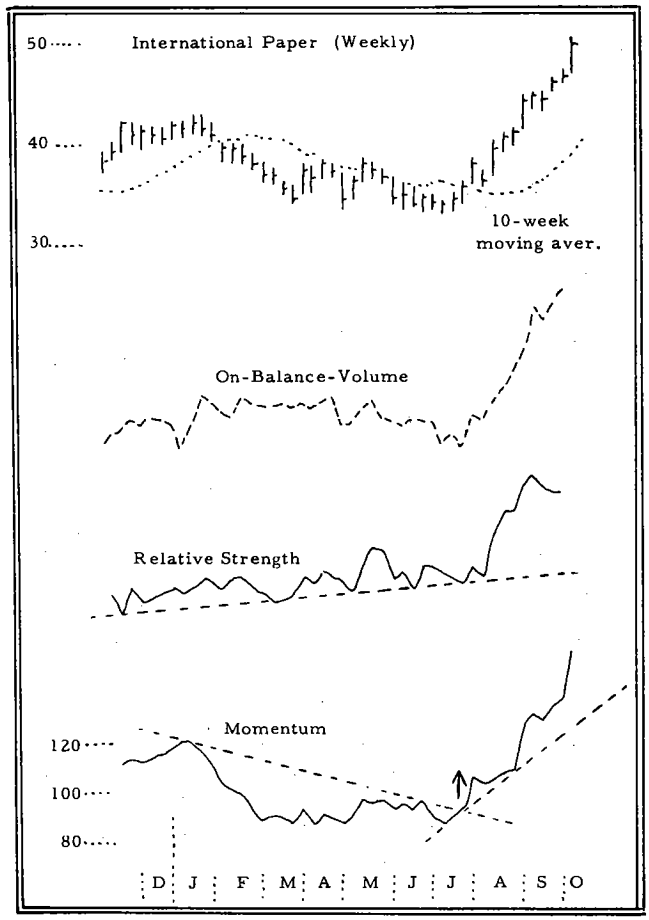
As to the price of gold and silver, I include my semi-logarithmic or ratio scale chart of the two metals. Since it is the nature of ratio charts to show percentages of movements, the action of both metals can be properly compared here. To me, the important thing to note is that the two metals are holding well above their rising trendlines, although



gold during 1973 moved far above the trendline while silver seems more prone to "hug" the line. It appears that both metals are in rather orderly uptrends, with a period of consolidation now occurring in gold.

Needless to say, gold is now consolidating while inflation is roaring, and as the world's money supply bubbles over, it will ultimately require more paper (of all denominations from yens to marks to dollars) to buy an ounce of gold. The rise in gold has been shouting "liars" to the men who handle the world's monetary affairs. Every comparable gold rise in history has been accompanied by violent dislocations and upheavals in the economic, social and political structure of the world. So far, my chart says that the rise in the yellow metal remains intact.

I have been listing the strongest Dow Industrial stocks in recent Letters, suggesting that subscribers who are willing to trade into this explosive market confine their purchases to these issues (on the thesis that if the Dow goes up, the strongest Dow stocks must go up). Powerful Dow stocks include Alcoa, International Paper, International Harvester, Esmark, Goodyear, Int. Nickel, Owens Illinois, Allied Chemical.



Few people understand the principle of relative strength (RS). RS deals with the action of the stock compared with the general market (I compare each stock with the broad S & P 500 Average, obtaining a ratio by dividing the price of the stock by the price of the S & P 500). One of the best times to "pick" strong stocks is during a broad market decline. If a stock's RS is rising during a market decline, the implication is that the stock is acting better than the market. The reason the stock is acting better is usually that it is under informed accumulation ("informed" because smart money usually prefers to accumulate during weak markets).

Refer to my weekly chart of International Paper. Note that all during the market decline of 1973 the RS on Paper was rising. This suggested accumulation, even though Paper was declining in price. This was bullish for Paper, in that it suggested that Paper would advance faster than the market on the next general market rise. Now turn to momentum, which is the ratio of a stock's price compared with its own price during a previous period (I use a 13-week span, dividing the price of the stock today by its price 13 weeks ago).

Note that even though Paper's RS was rising all through 1973, its momentum declined from January, 1973, through July. That meant that on a trend basis, Paper was continuing to drop below its own price of 13 weeks ago. In other words, Paper was declining (momentum) during January-July, but it was not declining as fast (relative strength) as the general market!

In July, Paper's momentum turned up. For the first time, the stock started to act better than its price of 13 weeks ago on a trend basis. By the end of July, Paper's momemtum climbed over 100, which meant that the stock's price was actually above its price of 13 weeks ago. Thus, by August we could say that Paper was continuing to act better than the market, and it was also acting better than its own price level of 13 weeks ago. This resulted in the violent advance which took Paper from the low 30's in July to above 50 in October.

The on-balance-volume in Paper obviously confirmed the whole movement. OBV is computed like an A-D ratio of volume. If the stock is up for the day, all the volume for that day is added to a running total, the converse being the procedure if the stock is down for a given day. In August OBV on Paper broke out, indicating that buyers had triumphed, and that all was clear on the upside from the standpoint of supply and demand.

Confirmation was also provided in July by the 10-week moving average, which was decisively bettered and not even "tested" on the subsequent violent advance. On my technical tabulations, Paper was given a point total of plus 4 out of a peak possible total of 5. This was so because the four technical studies had turned bullish, RS, momentum, OBV and the 10-week moving average. Only a rising trend in the stock's short interest was lacking. Paper, at present, does not have enough shorts to warrant inclusion of the short interest figures on its chart. If it did, it would receive a peak bullish total of 5.

In Letter 573 (August 29) I stated that "the strongest reading goes to International Paper" and number two spots were registered by Alcoa, International Harvester and International Nickel. In Letter 574 (Sept. 7) I added Owens Illinois to the strong list. Letter 576 (Sept. 28) added Allied Chemical and Esmark to the strong list.